

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Docket Nos. UG-110723  
Puget Sound Energy, Inc.'s  
Tariff filing for Pipeline Integrity Program

PUBLIC COUNSEL DATA REQUEST NO. 035

PUBLIC COUNSEL DATA REQUEST NO. 035:

Please provide all credit rating agency reports or analyst reports relating to PSE, PSE Energy, or PSE Holdings issued within the last 18 months.

Response:

Puget Sound Energy, Inc. ("PSE") objects to Public Counsel Data Request No. 035 to the extent it seeks information that is neither relevant to the issues in this proceeding nor reasonably calculated to lead to the discovery of admissible evidence. PSE further objects to Public Counsel Data Request No. 035 as overly broad and unduly burdensome taking into account the needs of the adjudicative proceeding. In particular, this objection applies to requested information related to Puget Holdings. Without waiving such objections, and subject thereto, PSE responds as follows:

Attached as Attachment A to PSE's Response to Public Counsel Data Request No. 035, please find credit rating agency or analyst reports relating to PSE and Puget Energy issued within the last 18 months. There are no credit rating reports issued for Puget Holdings.

**MOODY'S**  
 INVESTORS SERVICE

Credit Opinion: Puget Energy, Inc.

Global Credit Research - 17 Mar 2011

United States

**Ratings**

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba1
Sr Sec Bank Credit Facility	Ba1
Senior Secured	Ba1
<b>Puget Sound Energy, Inc.</b>	
Outlook	Stable
Issuer Rating	Baa2
First Mortgage Bonds	A3
Senior Secured	A3
Sr Unsec Bank Credit Facility	Baa2
Senior Unsecured Shelf	(P)Baa2
Commercial Paper	P-2
<b>Puget Sound Energy, Inc. (Old)</b>	
Outlook	No Outlook
First Mortgage Bonds	Baa1
Bkd Senior Secured	A3
Bkd Jr Subordinate	Baa3
<b>Washington Natural Gas Company</b>	
Outlook	No Outlook
Bkd First Mortgage Bonds	A3

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**Key Indicators**

Puget Energy, Inc. (The)	31-Dec-2008	31-Dec-2009	31-Dec-2010
Adj CFO (pre w/c) / Debt	16.2%	14.4%	10.0%
Adj CFO (pre w/c) + Interest / Interest	3.9x	3.3x	2.5x
Adj CFO (pre w/c) - Dividends / Debt	12.9%	11.8%	8.0%
Debt / Capitalization	56.1%	50.4%	53.4%
Adj Net Income / Common Equity	6.8%	1.2%	2.5%
Common Dividends / Adj Net Income	79.8%	356.0%	123.6%

Note: For definitions of Moody's most common ratio terms please see the accompanying *User's Guide*.

**Opinion**

**Rating Drivers**

Parent holding company with ownership of one core subsidiary - sole focus on regulated electric and gas utility operations

Collaborative regulatory relationships and credit supportive regulatory practices

Negative free cash flow creates external financing needs

Ring-fence-like mechanisms protect subsidiary to the potential detriment of the parent's credit quality; parent also subject to certain dividend restrictions

**Corporate Profile**

Puget Energy, Inc. (PE), is a holding company whose sole business is conducted through its subsidiary, Puget Sound Energy, Inc. (PSE), an electric and natural gas utility serving about 1.1 million electric and 750,000 natural gas customers in the State of Washington (primarily in the Puget Sound region). In 2010, the company's electric operations accounted for 67% of revenue and gas 33%.

On February 6, 2009, PE was acquired by Puget Holdings LLC, a consortium of private equity investors led by Macquarie Infrastructure Partners, and PE became a direct wholly-owned subsidiary of Puget Equico LLC, which is an indirect wholly owned subsidiary of Puget Holdings. PSE continues to be regulated by the Washington Utilities and Transportation Commission (WUTC) and the Federal Energy Regulatory Commission.

#### Recent Events

On March 16, 2011, Moody's upgraded all long-term ratings of PE and PSE by one notch and assigned a stable outlook. At the same time we upgraded PSE's short-term rating to P-2 from P-3. The rating action was reflective of a number of considerations including the relative stability in operations observed following the company's buyout in February 2009, as well as the progress being made to extend the maturity profile, at the PE level, of debt that was used to help finance the acquisition. Prospectively, we believe the utility's capital spending will peak in 2011 resulting in a higher level of retained cash flow in 2012. Additionally, we expect the company will seek authorization from the Washington Commission for rate increases at both the electric and gas businesses sometime in 2011 (effective 2012), providing an opportunity for stronger positioning at its current rating category.

#### SUMMARY RATING RATIONALE

Underpinning Puget Energy's rating is the ownership of its operating subsidiary Puget Sound Energy. PSE's Baa2 senior unsecured rating reflects its relatively low risk utility operations, collaborative regulatory relationships and recent credit supportive rate case outcomes, efficient handling of electric and gas supply needs, solid credit metrics, and access to its own committed bank credit facilities plus indirect access to the parent's committed capital expenditure facility to supplement internal cash flow. PSE's primary near-term challenge includes our expectations for considerable negative free cash flow through 2011 given capital spending plans. Careful management of its significant power and gas supply contracts will continue to be a longer-term rating consideration.

At two notches down from PSE's Baa2, PE's Ba1 senior unsecured issuer rating reflects a wider than typical one-notch down of a corporate parent due to structural subordination. This is due to our view of the increased financial risk as almost \$1.5 billion of standalone debt now exists following the February 2009 ownership change (approximately 25% of consolidated debt at December 31, 2010 was borrowed at the PE holding company level). The wider notching also considers the weaker consolidated cash flow metrics and the ring-fence-like mechanisms in place to protect investors at the PSE level, which could potentially limit the upstream of distributions to service the standalone parent debt.

#### DETAILED RATING CONSIDERATIONS

##### CONSERVATIVE REGULATED UTILITY FOCUS

PSE's electric utility operations include its regulated generation, transmission and distribution operations in the State of Washington. By customer count, approximately 88% of electric and 92% of PSE's gas customers are residential. Measured by sales, residential customers accounted for 41% and 51% of electric and gas revenues, respectively. In 2010, PSE's average retail electric cost per residential customer was 10 cents/kWh, a 5.6% increase from the previous year and below the US average; not surprising given the hydro availability.

The company has a conservative utility focus but also some unique attributes. For example, while viewed as a mid-size utility business, PSE is short internally-generated power and has extensive supply agreements to meet its total load requirements. In 2010, approximately 50% of the company's energy production was purchased. These large short-term and long-term purchase agreements need to be managed carefully and as such, liquidity is a heightened area of focus for PSE. Nevertheless, despite a \$398 million gross liability position related to hedging activity (61% electric / 39% gas) at December 31, 2010, the company reported that it was not required to post collateral with counterparties.

Additionally, we note the company elects to classify their hedging activity as fair-value and as such, unrealized non-cash changes in the derivative positions impact the income statement directly. While this increases the "noise" in earnings we look through the accounting convention and focus on cash flow which should be unaffected. Long-term, PSE's electric supply strategy focuses on increasing energy efficiency, while also adding renewable (mostly wind) and natural gas supply sources. These additions reduce PSE's dependence on hydro, which we see as beneficial given past supply cost issues due to persistent drought conditions.

##### COLLABORATIVE REGULATORY RELATIONSHIPS AND CREDIT SUPPORTIVE REGULATORY PRACTICES

As noted above, among the most significant risks that PSE faces are hydro-electric generation variability and the wholesale market prices of natural gas and power. PSE embraces a collaborative regulatory approach in Washington that has been allowing more reasonable rate increases and providing risk-mitigating cost-recovery mechanisms (i.e., the power cost adjustment (PCA) and purchased gas adjustment (PGA) mechanisms). In our view the PCA and PGA are critical underpinnings of the rating given the potential variability in power supply and natural gas.

The regulatory framework in Washington also allows for power cost only rate cases (PCORC). APCORC allows PSE to revise electric rates after an expedited 5-month review of the company's power costs and new resources, instead of filing a traditional general rate case, which entails a comprehensive 11-month review of all utility costs. PSE's use of the PCORC process has helped minimize regulatory lag.

In its most recent electric rate case, the company was authorized a \$74 million, or 3.7%, rate increase in April 2010 (74% of requested amount, 48% equity, and 10.1% ROE). On the gas side, the company recently received approval to settle with the WUTC for authorization to implement a \$19 million, or 1.8%, rate increase.

Although we focus on cash flow, one area of concern has been the under-earning of ROE relative to authorized levels. For example, from 2008-2010 the average achieved ROE was 6.2% (Moody's calculation), well below the recent authorized level. Going forward we expect the company will seek additional rate increases for both gas and electric operations in mid-2011, providing at least the opportunity to achieve its allowed ROE through revenue growth. We note the most recent electric rate case in 2010 used a 2008 test year and authorized a 46% equity component, below the actual 48% reported by the company. We believe these two items, in part, explain some of the under-earning of ROE noted above.

The regulatory protections have become an increasingly important aspect of the analysis of PE and PSE given the standalone parent debt that

has already been introduced. Key among the strong ring-fence-like mechanisms established when the WUTC approved the change in ownership are: a required "golden share" vote to address concern about potential substantive consolidation of PSE in any parent bankruptcy and any voluntary filing by PSE; minimum required levels of PSE common equity to be maintained and limits on PSE and parent distributions under certain circumstances.

#### WHAT IS PSE SPENDING CAPITAL ON?

Combining maintenance and growth capex, PSE could spend close to \$2.5 billion over the next three years to support supply and delivery infrastructure needs. This is relative to cash from operations from 2008-2010 of \$1.8 billion. Although the future amounts remain subject to review and may change based on economic, regulatory, and other factors, we still expect the trend of higher than historical average capital expenditures to continue for the next 12-24 months. Accordingly, we expect periodic rate cases for PSE to minimize the effects of regulatory lag given the use of historical test years under Washington's regulatory practice. Notable projects include:

- Completion of the first phase of the Lower Snake River Wind Project. Originally a five-phase project (250 megawatts each), the plan is now revised with phase one being increased to 343MW's and the deferral of followings phases to future periods. The company expects that Treasury grants will help reduce the cost of the new generation and this was a consideration in the revised capex strategy. Target completion date is 2012 and total project cost is approximately \$840 million.
- Snoqualmie Falls Redevelopment - Scope of project includes the re-licensing of this existing asset and upgraded MW capacity. The \$240 million project has a 2013 target completion date.
- Baker River Redevelopment - Increasing hydro-electric capacity at an existing asset from 170MW to 200MW. Target completion is 2014 and cost is \$250 million.

The anticipated financing for the capex program is likely to be met from a combination of internal cash flow and utility issued debt, while targeting a capital structure that includes common equity equal to the level that regulators use in setting rates. Given the construction, bonus depreciation may also provide some near-term cash flow benefit. PSE has committed to keep a minimum common equity of 44% as calculated by the state regulators, unless the WUTC establishes some lower level as the basis for setting rates.

The investor consortium has now owned PSE for two years and has generally operated the company with no change of strategy from what was contemplated at the time of the acquisition. However, we note the ownership group has contributed no "new" equity since the initial acquisition. We expect that going forward managing the dividend will be a tool to adjust equity rather than new contributions. However, given the large size of the current capital program new equity would be viewed as credit supportive. Conversely, large dividend payments at the PSE or PE level would be viewed negatively.

#### KEY FINANCIAL METRICS IN LINE WITH EXPECTATIONS

PSE's results in 2010 generated CFO (pre-W/C) plus interest to interest and CFO (pre-W/C) to debt of 3.6x and 16.4%, respectively. These results compare well to the mid-range of the "Baa" category for utilities of 2.7-4.5x and 13-22%, for the same metrics. They are also slightly below the 3-year average on both measures. This was partly attributable to weather-related weakness in the early part of 2010 (2010 electric usage was down 4.4% and gas 9%) but also as 2009 results were impacted by movements in deferred taxes that positively impacted cash flow.

At the parent level, PE's results were also in line with expectations and the rating category. For example, CFO (pre w/c) to debt was 10%, approximate to the mid-point of the 5-13% range for the "Ba" category. We note as well that in addition to Moody's standard adjustments (pension, lease, and capitalized interest) we make an additional adjustment in the case of PE to remove the effect of "re-classified" derivative contracts at the time of acquisition.

PSE should have ample flexibility to comply with key financial covenants in its bank revolvers and regulatory mandates that govern its expected dividend distributions to the parent. The regulatory protections have become an increasingly important aspect of the analysis of PSE as substantial debt was introduced above the operating company for the first time when the ownership change occurred.

#### Liquidity

To supplement internal cash flow, PSE relies on three five-year committed credit facilities aggregating \$1.150 billion (i.e. \$400 million to support working capital and act as commercial paper back-up, \$350 million to support its energy hedging program, and \$400 million to provide another source of funding for utility capex). The facilities, which expire in February 2014, have a (4) day borrowing notice requirement with same day borrowing ability in an amount up to \$50 million.

Puget Energy's \$1.0 billion committed capex facility is available through February 2014 to support the planned utility investments as well. As of December 31, 2010, there was \$742 million of unused capacity under the parent's capex facility. Although PSE's liquidity should remain sufficient to meet its short-term working capital needs, liquidity will likely be stretched as external borrowings are made to fund anticipated negative free cash flow due to the large capex program.

The quality of the alternate liquidity provided by PSE's bank facilities benefits from not having any ongoing material adverse change (MAC) clause or any onerous financial covenant requirements (i.e. fairly low cash flow coverage tests as defined, which replace the former maximum allowed debt covenant in the prior facilities). We expect that PSE should maintain adequate headroom against the covenants given expected financial performance and there are no rating triggers in the bank facilities. The Puget Energy bank facility has various financial covenants that we don't currently expect to pose undue concerns; however, the quality of the alternate liquidity provided by this facility is of weaker quality than the PSE facilities given the ongoing nature of the MAC clause requirement for each borrowing. Like the PSE facilities, there are no rating triggers.

#### Rating Outlook

Puget Energy's rating outlook is stable, reflecting our view that prospective improvement in operating results at PSE could improve the credit profile of PE, absent a dividend policy that is not consistent with maintaining a near-investment grade capital structure.

#### What Could Change the Rating - Up

Given the recent rating action, and capital program at the utility, an upgrade in the near-term is unlikely. However, the ability to report consolidated CFO (pre w/c) plus interest to interest and consolidated CFO (pre w/c) to debt above 3.0x, and the mid-teens range, respectively, on a sustainable basis could provide impetus for positive rating action.

**What Could Change the Rating - Down**

Any aggressive debt-funded dividends could lead to a downgrade, especially if there is any unexpected decline in the WUTC's supportiveness. Moreover, shortfalls in consolidated financial performance that reduce consolidated CFO (pre-w/c) plus interest to interest and consolidated CFO (pre w/c) to debt well below 3.0x and 10%, respectively, for an extended period of time, could lead to a downgrade.

**Rating Factors**

Puget Energy, Inc.

Regulated Electric and Gas Utilities [1][2]	Dec-31-2010		Moody's 12-18 month Forward View As of March 16, 2011*	
	Measure	Score	Measure	Score
<b>Factor 1: Regulatory Framework (25%)</b>				
a) Regulatory framework		Baa		Baa
<b>Factor 2: Ability to Recover Cost and Earn Returns (25%)</b>				
a) Ability to recover Cost and Earn Returns		Baa		Baa
<b>Factor 3: Diversification (10%)</b>				
a) Market Position		Baa		Baa
b) Generation and Fuel Diversity		Baa		Baa
<b>Factor 4: Financial Strength, Liquidity &amp; Metrics (40%)</b>				
a) Liquidity		Ba		Ba
b) CFO (pre w/c) + Interest / Interest	2.5x	Ba	1.5 - 2.7x	Ba
c) CFO (pre w/c) / Debt	10.0%	Ba	5 - 13%	Ba
d) CFO (pre w/c) - Dividends / Debt	8.0%	Ba	0 - 9%	Ba
e) Debt / Capitalization	53.4%	Baa	45 - 55%	Baa
<b>Rating:</b>				
Indicated Rating from Grid		Baa3		Baa3
Actual Rating Assigned		Ba2		Ba2

\* THIS REPRESENTS MOODY'S FORWARD VIEW; NOT THE VIEW OF THE ISSUER; AND UNLESS NOTED IN THE TEXT DOES NOT INCORPORATE SIGNIFICANT ACQUISITIONS OR DIVESTITURES

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010; Source: Moody's Financial Metrics



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**STANDARD  
& POOR'S**

# Standard & Poor's Research

August 26, 2011

## Summary: Puget Sound Energy Inc.

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Rationale

Outlook

## Summary:

# Puget Sound Energy Inc.

Credit Rating: BBB/Stable/A-2

## Rationale

The 'BBB' corporate credit rating on Puget Sound Energy Inc. (PSE) primarily reflects the excellent business risk profile and aggressive financial risk profile of its steady integrated electric and gas utility operations. Parent Puget Energy Inc. (Puget) is rated two notches below the utility at 'BB+', reflecting consolidated financial measures that are weaker than PSE's due to additional debt leverage, and the disadvantage of insulating provisions pledged at the utility operating company that may limit dividends. Standard & Poor's Ratings Services views all the financial obligations of Puget as being disadvantaged relative to PSE debts and credit facilities. However, the relationship between these entities and a lack of other operating units constrains the degree of differentiation between the two credit ratings.

We view the package of regulatory commitments entered into during the merger settlement as providing a degree of insulation to PSE. The package includes the placement of independent directors on the utility's board of directors and dividend restrictions based on a 44% minimum equity level, a 3x EBITDA interest coverage test, and investment-grade ratings on PSE. Despite these minimums related to settlement commitments, a downgrade could occur if Puget does not manage the financial profile in a manner that supports investment-grade credit metrics on a consolidated basis.

The business risk profile of PSE is excellent, reflecting combined electric and gas utility operations focused in the Puget Sound region of Washington State. PSE is subject to regulation by the Washington Utilities and Transportation Commission. The company's management of its regulatory relationships in Washington is a key driver of credit quality, especially in light of PSE's relatively high capital needs and commodity price exposure. PSE's cost recovery mechanisms support credit quality. PSE passes all increases and decreases in the cost of natural gas supply on to customers through the purchased gas adjustment mechanism. The company also has flexibility in implementing rate changes through its power cost adjustment (PCA) mechanism, but the threshold it must meet to true up undercollected rates is high, and deferred costs are not automatically collected. Each year, uncollected costs are subject to defined sharing bands, allowing the company to defer certain portions for collection from customers. However, the PCA mechanism does not trigger a rate increase until a minimum deferral balance is reached. PSE is also able to update rates for changes in power costs by filing a power-cost-only rate case (PCORC), which gives it the flexibility to file for changes in variable and fixed costs whenever it projects a deferral balance of \$30 million or more. The PCORC functions as a mini-rate case that takes about five months, and is especially useful for new plant additions or contracts. The use of this mechanism, combined with frequent general rate case filings, has allowed the company to keep deferral balances low and better match actual costs with cash collected.

PSE's consolidated financial risk profile is aggressive under Standard & Poor's corporate risk matrix. Consolidated adjusted funds from operations (FFO) to total debt was 12.3%, excluding reclassified derivative contracts, for the 12 months ended June 30, 2011, bolstered by cooler weather and higher rates at the utility. Adjusted debt to debt and equity -- including debt adjustments for operating leases, purchased power, and hybrid equity -- was 60% as of



*Summary: Puget Sound Energy Inc.*

June 30, 2011. A weakening of the financial profile at PSE could restrict its dividends to Puget, pursuant to the company's commitments approved by state regulators, or limit the availability of credit facilities due to financial covenants. We expect adjusted FFO to total debt to average no less 12%, and we expect no further elevation in debt leverage, beyond 60%, for PSE to retain the current ratings. PSE's adjusted FFO to average total debt was 19.5% for the 12 months ended June 30, 2011, and adjusted debt to capital was 53%.

Capital requirements are very high at PSE, with infrastructure replacement, renewable portfolio standards, and other new resource requirements driving planned capital expenditures of \$1,053 billion in 2011 and \$737 million in 2012. We anticipate ongoing periodic external financing at Puget and PSE to supplement the gap between internal cash and capital expenditures, to maintain a stable capital structure. PSE needs to carefully manage capital plans, expenses, and dividends to avoid excessive debt usage to maintain the financial profile through the current period of heavy capital spending.

### **Liquidity**

The short-term rating on PSE is 'A-2'. Puget and PSE's consolidated liquidity is strong under our corporate liquidity methodology, which categorizes liquidity under five standard descriptors. Projected sources of liquidity (mainly operating cash flow and available bank lines) exceed projected uses (mainly necessary capital expenditures, debt maturities, and common dividends) by more than 2x for the upcoming 12 months.

PSE has three committed unsecured revolving credit facilities that provide, in aggregate, \$1.15 billion in short-term borrowing capability. These facilities include a \$400 million credit agreement for working capital needs, a \$400 million credit facility for funding capital expenditures, and a \$350 million facility to support other working capital and energy hedging activities. As of June 30, 2011, PSE had only a \$12.5 million letter of credit on the working capital facility, and nothing drawn or outstanding under the capital expenditure facility or the hedging facility. These facilities mature February 2014.

Effective with the close of the merger, Puget had a \$1.225 billion five-year term loan. In June, Puget issued \$500 million of senior secured notes due 2021, using the proceeds to repay a portion of the term loan. Prior to this, Puget issued \$450 million due 2020 to refinance term loan balances. Only \$298 million remains outstanding. Puget also uses a \$1 billion credit facility for funding capital expenditures at PSE. As of June 30, 2011, \$258 million was outstanding under the capital expenditure facility. The outstanding term loan balance and the capital expenditure facility mature February 2014. Puget's credit agreement contains financial covenants that can limit its availability.

### **Recovery analysis**

We rate PSE's first mortgage bonds (FMB) 'A-', two notches higher than the issuer credit rating, with a recovery rating of '1+'. We assign recovery ratings to FMBs issued by U.S. utilities, and this can result in issue ratings being notched above the corporate credit rating (CCR) on a utility, depending on the CCR category and the extent of the collateral coverage. The investment-grade FMB recovery methodology is based on the ample historical record of nearly 100% recovery for secured-bond holders in utility bankruptcies and our view that the factors that supported those recoveries (small size of the creditor class and the durable value of utility rate-based assets during and after a reorganization, given the essential service provided and the high replacement cost) will persist. Under our notching criteria, we consider the limitations of FMB issuance under the utility's indenture relative to the value of the collateral pledged to bondholders, management's stated intentions on future FMB issuance, and the regulatory limitations on bond issuance when assigning issue ratings to utility FMBs. FMB ratings can exceed a utility CCR by as much as one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade

*Summary: Puget Sound Energy Inc.*

categories. (See "Criteria: Changes To Collateral Coverage Requirements For '1+' Recovery Ratings On U.S. Utility First Mortgage Bonds," published Sept. 6, 2007, on RatingsDirect on the Global Credit Portal.) PSE's collateral coverage of more than 1.5x supports a recovery rating of '1+' and an issue rating of 'A-', two notches above the CCR.

## Outlook

The stable outlook on the PSE ratings reflects our expectation that the company will be able to refinance term loans and credit facilities well in advance of the 2014 expiration and that Puget will prudently manage financial risks such that it maintains consolidated credit metrics that are within our aggressive financial category on a consolidated basis, including consolidated adjusted FFO to debt of more than 12% and adjusted debt to debt and equity of no more than 60%. The stable outlook also reflects reasonable and timely rate relief related to resource additions and changes in power costs at PSE, as well as our expectation that PSE will internally fund significant capital expenditures. We could lower the PSE rating if Puget increases consolidated adjusted debt leverage to more than 60% due to excessive debt financing, if PSE's adjusted FFO to debt trends below 16%, if it is unable to fully recover investment costs due to cost disallowances, or if the ownership consortium collects larger dividends that directly result in weaker consolidated credit metrics, including adjusted leverage of more than 60%. We could raise the rating if Puget is able to sustain significantly higher credit metrics on a consolidated basis, specifically adjusted FFO to debt above 15%. However, positive ratings momentum is unlikely at this time.

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